REPORT OF EXAMINATION

PEMCO LIFE INSURANCE COMPANY

As of December 31, 1997 and 1998

CHIEF EXAMINER'S AFFIDAVIT

I hereby certify I have read the attached Report of the Financial Examination of the PEMCO LIFE INSURANCE COMPANY of Seattle, Washington. This report shows the financial condition and related corporate matters as of December 31, 1998.

Patrick H. McNaughton

Patrick H. McNaughton, Chief Examiner

PEMCO LIFE INSURANCE COMPANY

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Seattle, Washington
October 24, 2002

The Honorable Alfred W. Gross
Commissioner, Commonwealth of Virginia
Bureau of Insurance
Chair, NAIC Financial Condition Committee
PO Box 1157
Richmond, VA 23218

The Honorable Merwin Stewart
Commissioner, Utah Department of Insurance
NAIC Secretary, Western Zone
3110 State Office Building
Salt Lake City, UT 84114-1201

The Honorable Mike Kreidler
Insurance Commissioner, State of Washington
PO Box 40255
Olympia, WA 98504-0255

Dear Commissioners:

In accordance with your instructions and in compliance with the statutes of the state of Washington, Chapter 48.03 Revised Code of Washington, an Examination has been made of the corporate affairs and financial records of the

PEMCO LIFE INSURANCE COMPANY
of
Seattle, Washington

hereinafter referred to as the Company, at its home office located at 325 Eastlake Avenue East, Seattle, Washington 98109-5466. The following report on the examination is respectfully submitted showing the condition of the Company as of December 31, 1997 and 1998.

SCOPE OF EXAMINATION

The previous examination of the Company was made as of December 31, 1992. The current examination conducted by insurance examiners from the state of Washington covered the period from January 1, 1993 through December 31, 1998. The examination was conducted in accordance with the laws and regulations of the state of Washington contained in Title 48 of the Revised Code of Washington (RCW), Title 284 of the Washington Administrative Code (WAC), and the examination procedures recommended by the National Association of Insurance Commissioners found in the NAIC Financial Condition Examiner's Handbook.

Corporate records and various aspects of the Company's operating procedures and financial records were reviewed and tested during the course of this examination and are commented upon in the following sections of this report. The Company's certified public accountant's work papers were reviewed and utilized where possible to support efficiency in the examination.

INSTRUCTIONS

Pursuant to the findings and conclusions of the examiners and actuary, in accordance with sound actuarial principals, Title 48 RCW, Title 284 WAC and the NAIC Accounting Practices and Procedures Manual (APPM) for life, accident and health insurance companies, the Company is hereby instructed to comply with the following:

1. **THE COMPANY IS INSTRUCTED** to comply with **WAC 284-02-080** and file all amendments to its bylaws with the insurance commissioner. Reference "CORPORATE RECORDS" **(page 6)**.

2. **THE COMPANY IS INSTRUCTED** to comply with **WAC 284-07-050(2)** which requires adherence to the appropriate Annual Statement Instructions and the Accounting Practices and Procedures Manuals promulgated by the NAIC for the completion of the annual statement. **RCW 48.05.250** requires the Company to file with the insurance commissioner a true annual statement of its financial condition, transactions, and affairs.

   Reference "CORPORATE RECORDS" **(page 6)**, "ACTUARIAL" **(pages 12 and 13)**, and "NOTES AND COMMENTS TO FINANCIAL STATEMENTS, #8 ASSET VALUATION RESERVE" **(page 22)**.

3. **THE COMPANY IS INSTRUCTED** to comply with **RCW 48.05.280** and keep full and adequate accounts and records of its assets, obligations, transactions, and affairs.

   Reference "CORPORATE RECORDS" **(page 6)**, "AGREEMENTS" **(page 8)**, "INTERNAL SECURITY" **(pages 8 and 9)**, and "ACTUARIAL" **(page 13)**.

4. **The COMPANY IS INSTRUCTED** to comply with **RCW 48.07.040** and hold an annual meeting of its shareholders or members at such time and place as may be stated in or fixed in accordance with its bylaws. Reference "CORPORATE RECORDS" **(pages 6 and 7)**

HISTORY

PEMCO Life Insurance Company (PLIC) is a Washington corporation organized as a stock insurance company on May 27, 1963. The Company's Certificate of Authority was issued on June 11, 1963 and authorized the business of life and disability insurance. The Company is a wholly owned subsidiary of PEMCO Corporation.

CAPITALIZATION:

Pursuant to RCW 48.06.040, the Company obtained a solicitation permit on May 27, 1963 to sell 12,500 shares of $10 par value common stock. In accordance with the Application for Solicitation Permit, all authorized shares were issued to Teachers Credit Cooperative, a Washington Cooperative Association. An additional $6 per share was collected as contributed surplus. Total consideration was received in the amount of $200,000 and was divided, $125,000 in paid up capital and $75,000 as contributed surplus.

Pursuant to RCW 48.06.180, the Company obtained a solicitation permit for subsequent financing on January 14, 1969 to sell 100,000 shares of $10 par value, non-voting Class A common stock. Under provisions of RCW 48.06.070 and RCW 48.06.100, the solicitation permit was modified two times, extending the permit until January 14, 1975. The Class A common stock was never issued.

PEMCO Corporation (CORP) acquired all assets and liabilities of Teachers Credit Cooperative during 1973, giving CORP 100% ownership of PEMCO Life Insurance Company. CORP has been the only shareholder since 1973 and no change to the capital has occurred since 1969.

As of the examination date, the authorized capital stock consists of 112,500 shares of $10 par value common stock. Common stock issued and outstanding remains at 12,500 shares of $10 par value common stock or $125,000 and surplus contributions remain at $75,000.

SHAREHOLDERS DIVIDEND DISTRIBUTIONS:

The Company had sufficient earnings and surplus in all of the years under examination to pay dividends to its only shareholder, PEMCO Corporation. On December 2, 1993, the Company declared a dividend payable to the stockholder of record as of December 17, 1993.

The dividend amount of $262,500 was based on 1992 operating income. The Company did not declare or distribute shareholder dividends during the remaining period of examination and none were declared or distributed in 1999 and 2000 subsequent to the examination period.

AFFILIATED INSURANCE COMPANIES

PEMCO Mutual Insurance Company (PMIC) is organized as a mutual insurer in the state of Washington. The Company is licensed to operate only in the state of Washington and writes multiple-lines property and casualty coverage for the general public.

PEMCO Corporation (CORP) is a stock company that was incorporated in the state of Washington during April 1963.

CORP currently provides data processing services, and leases automobiles and office equipment to the three insurance companies, the Public Employees Insurance Agency and the other companies under common management. The services are purchased per agreement.

PEMCO Insurance Company (PIC) was incorporated on May 4, 1972, as a stock multiple line property and casualty insurance company under the laws of the state of Washington. PIC is licensed to operate only in the state of Washington. The Company's Certificate of Authority was issued on August 22, 1972 and authorized the business of property, vehicle, casualty and surety insurance.

NON-INSURANCE COMPANIES UNDER COMMON MANAGEMENT

Public Employees Insurance Agency (The Agency) is a stock company incorporated in the state of Washington during October 1968. The Agency sells insurance and collects premium on behalf of the affiliated insurance companies.

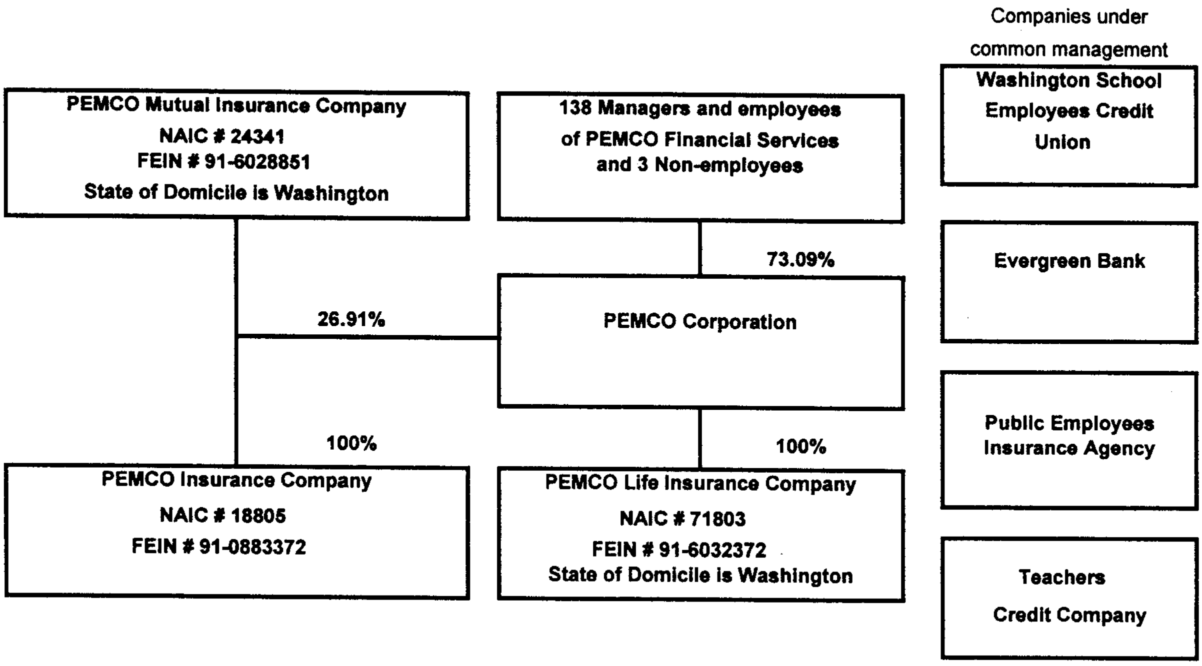
Washington School Employees Credit Union (WSECU) was founded by Robert J. Handy and a group of educators in 1936. Today, the Credit Union is one of the largest members owned credit unions in the state with more than 63,000 members, serving school employees and their relatives who live in Washington.

Evergreen Bank (EB), formerly Teachers State Bank, was incorporated under the laws of the state of Washington on December 28, 1970 and commenced business on October 1, 1971. EB provides banking services for all affiliated companies more than 8,200 other businesses and individual customers. EB has offices in Lynnwood and Seattle and they provide a wide range of products and services, including deposit accounts, loans, and investments.

Teachers Credit Company (TCC) was incorporated under the laws of the state of Washington during 1941. TCC retains and exercises the proxy votes of the policy holder members of the mutual company, PMIC.

ORGANIZATIONAL CHART

The following organizational chart displays the relationship of all of the affiliates under the PEMCO holding company system and other affiliated companies under common management.



Note: The affiliated companies under the holding company system do not have any ownership interest in the companies listed under common management, other than PMIC owning 22,000 shares (3.3%) and PIC owning 10,000 shares (1.5%) of Evergreen Bank common stock.

MANAGEMENT and CONTROL

BOARD OF DIRECTORS:

Control of the Company is vested in the Board of Directors (BOD) consisting of 6 members as of December 31, 1998. The BOD is elected at the annual stockholders meeting for a one-year term. The BOD was composed of five members throughout the period of examination until May 1998 when a sixth director was added by resolution of the BOD at the annual stockholders meeting.

Name and Address	Principal Business Affiliation	Member Since
Stan W. McNaughton	President and CEO & BOD, PLIC President and CEO & BOD, PMIC President and CEO & BOD, PIC	1998
Robert W. Howisey	Chairman BOD, PLIC Vice Pres. & Treasurer, PMIC Vice Pres. & Treasurer, PIC	1963
Hugh R. McGough	Secretary & BOD, PLIC PEMCO Financial Services, Legal Affairs	1994
Steven A. Ricco	BOD, PLIC	1998
Diane K. Beckley	BOD, PLIC	1998
Gayle C. Glass	BOD, PLIC	1989

OFFICERS:

Officers are elected at the annual Board of Directors' meeting for a one-year term. Officers on December 31, 1998 were:

Stan W. McNaughton	President and Chief Executive Officer
Hugh R. McGough	Corporate Secretary
Leslie J. Brandli	Treasurer

COMMITTEES:

PEMCO Life Insurance Company's corporate bylaws provide that the Board of Directors may establish an Executive committee or other permanent or temporary committees and vest therein, such powers, as the Board deems proper. There were no committees designated by the Board of Directors throughout the examination period ending December 31, 1998.

CORPORATE RECORDS:

The initial **Articles of Incorporation** were adopted by the Board of Directors May 23, 1963. There has been only one amendment during 1969 when the authorized capital was increased from 12,500 shares to 112,500 shares of $10 par value stock. No amendments have been made to the Articles of Incorporation during the period of this examination or in the subsequent two-year period, 1999 and 2000. The amendment was authorized by the Board of Directors and filed with the state of Washington in accordance with the Washington Insurance Code.

The **corporate bylaws** have been amended four times since the original bylaws were adopted on May 23, 1963. The first amendment was made on March 2, 1966 to Article VI, Officers, Section 1, where erroneous wording was modified to clarify what multiple positions the corporate officers may hold.

The second and third amendments were made during the period of this examination. On October 16, 1995, Article XV, Funds and Checks, Sections 1 and 2, were amended to add the phrase, "or electronic fund transfers" to modify the words "check" or "checks" wherever they appear. A new article regarding indemnification of directors, officers or employees of the Company was added on August 4, 1998, to replace the existing Article XVII. At the same time the existing Article XVII, Amendments, was renumbered to Article XVIII.

The Company did not hold the annual stockholders meeting on the date prescribed in its bylaws and Washington Insurance Code at anytime during the period of the examination **(see Instruction 4)**. The bylaws also require written notice and specific timing requirements for such written notice. These notices were not provided with the corporate documents reviewed **(see Instruction 3)**.

Article III, Stockholders' Meetings, Section 2 was amended subsequent to the examination date on April 16, 1999 when the BOD recognized that the annual stockholders' meetings had not been held at the time specified in the bylaws. The time was changed to, "on or before May 15th" of each year. This change brought the Company into compliance with the bylaws.

RCW 48.07.040 required annual stockholders' meetings to be held on or before April 30th of each year. Effective, June 13, 2002, **RCW 48.07.040** was amended to read as follows: Each incorporated domestic insurer shall hold an annual meeting of its shareholders or members at such time and place as may be stated in or fixed in accordance with its bylaws for the purpose of receiving reports of its affairs and to elect directors. This change brought the Company into compliance with the Washington Insurance Code.

The Board of Directors and the sole Shareholder authorized all changes to the corporate bylaws. However, none of the amendments were filed with the Insurance Commissioner as required by **WAC 284-02-080(8)** **(see Instruction 1)**. In addition, the general interrogatory question in the annual statements for each of the respective years, "Has any change been made during the year of this statement in the charter, by-laws, articles of incorporation, or deed of settlement of the company?", was answered, "No". **RCW 48.05.250** requires an annual statement without errors **(see Instruction 2)**.

PEMCO Corporation was the only stockholder during the examination period. All 12,500 shares were represented at the annual stockholders' meeting by proxy held by Robert W. Howisey. Mr. Howisey also served as Chairman of the Board of Directors into 1998 when Stan W. McNaughton was elected chairman. Mr. Howisey retired from the Board of Directors in1999

All of the annual stockholders' meetings were held during the last week of April or the first two weeks of May. The primary business was the election of the Board of Directors for the next one-year term.

The minutes of all Board of Directors' meetings held during the examination period (January 1, 1993 through December 31, 1998) and the subsequent two year period, 1999 and 2000, were reviewed for significant subject matter, an indication of member activity and participation. Board of Director activity was also reviewed with consideration for compliance with the Washington Insurance Code and compliance with the Company's Articles of Incorporation and Bylaws.

The Board of Directors met at least twice each year. The annual meeting of the Board of Directors is held each year immediately following the annual meeting of the stockholder, as prescribed in Article V, Section 1 of the corporate bylaws. The meeting is usually held during the last week of April or the first two weeks of May. At this meeting, the Board of Directors elect its' officers for the ensuing year, financial statements and reports for year end and the prior accounting period are reviewed and approved, depository resolutions are approved, investment policy is discussed and investment transactions occurring since the prior approval are approved. The Profit Sharing Plan is also discussed and appointments are made to its Administrative Committee.

A Special Meeting has been called usually in the month of December of each year. In addition to the regular topics of business discussed at the annual meeting, stockholder dividends, if any, are discussed and approved, and the annual bonus to employees is discussed and authorized. Other Board of Director business has been addressed throughout the year through signature of a document called, "Board Consent to Action Taken".

Article V, Section 2 of the corporate bylaws, calls for regular meetings of the BOD to be held every three months. Regular meetings were not held every three months as required in the bylaws. However, July 1998 marked the beginning of the Life Specialist program created to expand life product sales. At this time, the Board of Directors began meeting at least every three months as required **(see Instruction 4).**

The Board of Directors was active throughout the examination period, but activity increased the last half of 1998 and throughout 1999 and 2000. Meetings were well attended and the minutes were in sufficient detail and substance to demonstrate that the Board of Directors' members were actively involved in the administration of the affairs of the Company. All meetings were documented in written form, noting items of discussion and specific actions taken.

AGREEMENTS

The Company is a participant in several agreements among affiliates and, as a member of an insurance company holding system, these have been filed pursuant to RCW 48.31B.025. As of December 31, 1998, the Company was party to the following agreements:

Cost Sharing Agreements: The affiliated companies have extensive cost sharing activities among themselves. PEMCO Mutual Insurance Company owns the real estate occupied by the affiliated companies and leases specified space to the affiliated companies per periodic amendments to the Agreement of Lease. PMIC from time to time also procures products, supplies, and services on behalf of the affiliated companies.

PEMCO Corporation, per agreement, provides data processing services, and leases automobiles and office equipment to the three insurance companies, the Public Employees Insurance Agency, and the other non-insurance companies under common managment.

PMIC pays certain shared general expenses that benefit all of the affiliated companies. Reimbursement for products, supplies, and services is subject to a general "Reimbursement Agreement" dated January 1, 1990. Allocations are based on actual benefits received or by the same head count data that is used to allocate the expenses of the Supplemental Pension Fund. Affiliates are billed and reimburse PMIC on a monthly basis.

PMIC pays all expenses for PIC. PMIC is totally responsible for all non-auto line of business expense. All auto line of business expense is allocated between PMIC and PIC based upon a ratio of in-force policy counts at December 31st of the prior year. PIC reimburses PMIC for its share of expenses on a monthly basis.

Other ad hoc expense allocations occur based on specific contract or usage. A specific contract can be for a project, product, or service and is allocated based on an agreed percentage between two or more of the affiliated companies. Specific usage relates to vendor invoices that include goods or services that have been ordered by two or more or the affiliated companies, but are on one invoice. The affiliated company paying the invoice is reimbursed by the other affiliated companies on a monthly basis.

The following cost sharing agreements were in effect as of the examination date:

- Reimbursement Agreement (products, supplies and services)
- Lease Agreement (office space)
- Computer Service Agreement (software development and maintenance)
- Consulting Service Agreement (special projects)
- Master Equipment Lease Agreement (auto, computers, furniture and other equipment)

The Board of Directors' minutes do not show evidence of discussion of the elements of, or amendments to the various agreements as required by **RCW 48.05.280** **(see Instruction 3).**

Officers of each company signed the agreements, and procedures and guidelines followed by the company indicate that expenses were equitably distributed with no affiliated company gaining a marketing advantage because of inappropriate expense allocation. There were no other agreements that would indicate a material contingent exposure to the Company's assets. Settlement among the affiliates was on a monthly basis.

Agreement to Collect Premiums: The Washington School Employees Credit Union has agreed to collect life insurance premiums from its' customers who have chosen to purchase PLIC credit life coverage marketed through the Credit Union.

Insurance Agreement: PMIC has agreed to insure PLIC against the loss of unassigned surplus for the amount of surplus loss exceeding $500,000 as of December 31st in any year up to a maximum liability of $500,000. The annual premium is one per cent of the total gross income as shown on page 4, line 7, column 1 of the annual statement of the Company. Premiums are paid quarterly based upon gross income for each calendar quarter and adjusted, if necessary after completion of the Annual Statement.

INTERNAL SECURITY

Custodial Agreements: The PEMCO Life Insurance Company security custodial agreement effective July 28, 1993, contains the appropriate language set forth in the NAIC Financial Examiners Handbook. The agreement was signed by a bank official, but the copy provided to examiners was not signed by an authorized Company officer. The Company needs to prepare a fully executed securities custodial agreement for its records **(see Instruction 3).**

Conflict of Interest and Confidentiality Policy: The affiliated companies have a combined Conflict of Interest and Confidentiality Policy which requires the annual completion of a Conflict of Interest Statement by officers, directors, and key employees. All are required to disclose to the President, Chairman, or Board of Directors of the appropriate company, relevant outside interests, memberships, associations, and affiliations. All appropriate persons have complied with this policy. Conflict of Interest and Confidentiality Policy information is periodically discussed by and noted in the PMIC and PIC Board of Directors joint meeting minutes. This same discussion has not been noted in the PLIC Board of Directors' meeting minutes **(see Instruction 3)**.

The policy and the indicated activity by the affiliated companies demonstrate that the Company takes great effort to protect the confidentiality of the Company strategy, all records, data and any other information of a private or sensitive nature. No conflicts have been disclosed that would indicate a failure to give an undivided and unselfish loyalty to the company which demands that there be no conflict between corporate duties and self-interest.

Fidelity Bond and Other Insurance: A fidelity insurance policy is purchased by PEMCO Mutual Insurance Company and covers the affiliated companies. Coverage limits to $5,000,000 are provided for all of the affiliated companies insured. The minimum amount recommended by the NAIC is $1,500,000. The aggregate amount of coverage appears adequate to cover the exposure risk of the Company and its affiliates.

The Company is also provided protection against certain property and liability losses as a named insured on other policies obtained by PMIC. Policies in effect at December 31, 1998 provided coverages for real and personal property, commercial general liability, umbrella/excess liability, insurance agents/brokers professional liability, financial institution fidelity bond, fiduciary liability, directors & officers liability, errors & omissions liability.

EMPLOYEES' BENEFIT PLANS

All employees of the affiliated companies are eligible to participate in certain affiliated company sponsored insurance programs and benefit plans on the first of the month following an introductory period. Programs and eligibility vary according to employee status. Each company pays its own employees' salary and associated benefits.

The Company offers the following benefits: medical insurance, a dental assistance plan, long-term disability insurance, long-term care insurance, life insurance, optional life insurance, retiree medical, dental and other benefits.

The Company offers a 401(k) Savings and Profit Sharing Plan. This is a defined contribution plan where the employer pays eligible employees for their contributions to the continued success of the Company. One to ten percent of pay may be contributed to the plan with immediate 100% vesting. The Company contributes 200 percent matching on the first 6% of the employee contribution. Additional discretionary Company contributions may be made at the end of each year. After three years of service, the Company contributions are 30% vested and become fully vested after seven years of service. There are several options for withdrawal.

The Company also offers the usual options for time off from work including personal days, vacation, sick leave and the traditional holidays.

TERRITORY AND PLAN OF OPERATION

PEMCO Life Insurance Company is authorized to transact life and disability insurance in the state of Washington.

The Company redirected its efforts during 1998 to transform from a group and credit life insurer to an individual life insurer in order to meet the needs of the common customers of the affiliated companies. Growth opportunities are pursued through the existing customer relationships with a product emphasis on term, whole life and credit life products.

Term Plus, a five-year term product was introduced during 1992. During 1998, Secure Term (five, ten, fifteen, twenty and thirty year term) was introduced with standard rates and Cornerstone Whole Life was introduced with standard rates.

The following schedule shows the Company's direct writings:

Direct Business Writings Comparative Between Years								
(Schedule T – Premiums and Annuity Considerations)								
		1993	1994	1995	1996	1997	1998	1999
Washington	Life	759,177	976,576	982,593	879,218	827,950	891,607	1,018,235
	A & H	0	0	0	0	0	0	0
TOTAL		**759,177**	**976,576**	**982,593**	**879,218**	**827,950**	**891,607**	**1,018,235**

Direct premiums decreased 10.5% in 1996 and 5.8% in 1997. Gains of 7.7% were experienced during 1998 and 14.2% during 1999.

With the efforts that began during 1998, the Company continues to show growth. The number of new policies through September 2000 is 95% higher than the same period in 1999. The inforce policy count for the Secure Term product alone has increased 165% during the same period.

The Company primarily appoints agents that represent PMIC and PIC. Currently, there are 215 licensed agents representing the Company. Over one half of the property and casualty insurance sales force are direct sales representatives and as such the Company is not competing for position within their agency as they do in the traditional independent or community agencies. The Company will continue with its multiple distribution channel strategy using the both direct sales and community agents.

REINSURANCE PROGRAM

PEMCO Life Insurance Company has reinsurance for four lines of business with two authorized reinsurance companies in the state of Washington. The four lines are LifeLine, Term Plus, Cornerstone Whole Life, and Secure Term. LifeLine and Term Plus were not being offered as of December 31, 1998.

The Company retains only $25,000 on its' Lifeline policies and cedes out the remaining. There are only four policies outstanding and the inforce amount on these policies is $174,753 as of December 31, 1998.

The Term Plus policies including waiver of premium and accidental death benefits were reinsured with Employer's Reinsurance Corporation through June 30, 1997. The Company retained $65,000 under this contract and ceded the excess amount. The maximum ordinary reinsurance limit was $335,000 for life and $250,000 for accidental death benefits.

Effective July 1, 1997 the Company changed reinsurer's to Business Men's Assurance Company of America (BMA). All new ordinary and accidental death policies written subsequent to this date will be reinsured by BMA. The Company retains $100,000 of risk and cedes the balance up to a maximum ordinary reinsurance limit of $750,000 per policy. The Company may enter into facultative arrangements to insure the additional amounts up to the maximum amount of $1,000,000 per policy. This reinsurance agreement includes Term Plus policies issued after July 1, 1997, and Cornerstone Whole Life.

Effective July 1, 1998, the Company renegotiated its contract with BMA on Secure Term policies issued after the effective date. The Company retains 30% of the risk and cedes the balance. The retained amount cannot exceed $100,000. The maximum amount per policy is $1,000,000.

A summary of the PEMCO Life Insurance Company Reinsurance Program as of December 31, 1998 would be as follows:

Coverage Type	Retention	Limits	Levels
LifeLine decreasing term	$25,000		The excess of $25,000 is reinsured 100%
Term Plus 5 year level term issued prior to July 1, 1997	$65,000	$1,000,000 per individual	The excess of $65,000 is reinsured 100%
Term Plus 5 year level term issued after July 1, 1997	$100,000	$1,000,000 per individual	The excess of $100,000 is reinsured 100%
Cornerstone Whole Life	$100,000	$1,000,000 per individual	The excess of $100,000 is reinsured 100%
Secure Term	30/70 Quota Share	$1,000,000 per individual	The excess of $100,000 is reinsured 100%

The contracts have the standard insolvency clause wording required by Washington Insurance Code to minimize the Company risk. The Company does not do business with unauthorized reinsurers.

The President and the Life Company Manager routinely review the reinsurance program to be sure that the exposure to risk is limited through the spreading of that risk through the various reinsurance contracts.

INFORMATION SYSTEMS AND ACCOUNTING RECORDS

PEMCO Corporation provides all of the affiliated companies with EDP services. The management of CORP is sufficiently knowledgeable of EDP issues and the various department managers work with the IS Department to provide direction and oversight. Systems development, acquisition, and maintenance controls were evaluated to gain assurance that programs and systems are designed, tested, approved, and implemented using appropriate controls. The Company has detailed written documentation for its major operations and financially significant applications, proper supervision and review for each project to ensure satisfactory completion, and an Internal Audit Department that includes an EDP specialist.

Operations, processing, and documentation controls were reviewed to determine the type of hardware installed; operating systems and proprietary software in use; back up and recovery facilities employed; and the controls exercised to maintain data security. Adequate procedures and controls are in place for its mainframe operations and PC's.

The Company has also prepared a detailed written contingency plan to ensure its ability to service the needs of its policyholders in the event of any unforeseen circumstances.

ACTUARIAL

A life actuary employed by the Office of Insurance Commissioner, state of Washington, performed the actuarial review of the reserves and related assets and liabilities associated with policy coverages in group, credit and individual life insurance contracts underwritten by the Company.

The Company provided copies of its actuarial work papers and reserve reports as of December 31, 1998 and copies of its paid claims listings for 1999. Tests were performed on the Company's underlying data, methods, and calculations as deemed necessary. Tests were also performed on the valuation reports and on Company procedures to establish that accurate and complete in-force information as of December 31, 1998 was represented in the valuation reports and work papers. A sampling of contracts and payments was also taken from active life and disabled life reserve reports, premium collection records and paid claims reports. They were tested for completeness and accuracy.

During the course of the examination, the actuary also performed such testing of the Company's reserving methodologies and philosophies as the actuary deemed necessary to form an opinion with respect to the asset and liability items reported. The actuary relied upon listings and summaries of in-force policies and contracts that were furnished by the Company.

The general examination emphasis was to review the methods, assumptions or other bases used to determine the reported annual statement items, and to determine whether the reported amounts are sufficient and in compliance with Washington Insurance Code.

The Company has not completed various items in the annual statement according to the Annual Statement Instructions pursuant to **WAC 284-07-050(2)** and **RCW 48.05.250** **(see Instruction 2).**

Exhibit 1 does not include correct values for advance premiums, credit insurance premiums, premiums for reinsurance ceded, and reinsurance commissions and expense allowances **(see Instruction 2).**

Exhibit 8, Interrogatory 3, does not state the Company's determination procedure and does not include complete or accurate answers to the related eight interrogatories. The Company must address issues related to the non-guaranteed premiums that are less than the reinsurance premiums; its intentions relative to a 30-year level premium term plan for which it has not established appropriate reserves including the low mortality rates needed to support the plan; and its intentions relative to excess credits in a plan that it describes as "interest sensitive," but is labeled "non-participating" **(see Instruction 2).**

Note 11.c to the Annual Statement was not completed correctly because it did not reflect Term Plus and Secure Term policies for which the gross premiums are less than the net premiums according to the standard of valuation required by **RCW 48.74.070** **(see Instruction 2).**

Note 13 to the Financial Statements does not support the entry on the asset page 2 for life insurance premiums deferred and uncollected because the company incorrectly used the gross premiums figure rather than gross premiums net of loading **(see Instruction 2).**

The Credit Insurance Experience Exhibit does not separate life from disability, single premium from monthly outstanding balance, nor does it reflect premiums, premium refunds, premium reserves, or prima facie rates **(see Instruction 2)**.

Secure Term deficiency reserves should be reported in Exhibit 8, Part G, and not in Part A **(see Instruction 2)**.

The accuracy of the 1998 reinsurance ceded premiums and reserves could not be determined because the December 31, 1998 valuation report was unavailable and the Company chose not to replace it because of the uncertainty of cost involved in producing it in a timely manner. Prior years and the 1999 valuation report were available to test the accuracy of all other years' reinsurance ceded premiums and reserves **(see Instruction 3)**.

The valuation system used by the Company does not accurately report details regarding business in force, reserves and net premiums, and gross due, deferred and advance premiums. Without this, loading and cost of collection is difficult to determine. The system should also reflect separate figures for reserves reinsured and for deficiency reserves **(see Instruction 3)**.

Claim files did not contain relevant data, such as report dates, communications between the Company and the claimant, reasons for waiving requirements such as timely notice, or basic coverage information **(see Instruction 3)**.

The Company has understated the reserve credit taken for the Secure Term plan, and has taken a coinsurance reserve credit for the Term Plus plan, which was reinsured on a YRT basis **(see Instruction 2)**.

Reserves have been generated for the Family Life plan using net premiums that change with the death benefit instead of with the gross premiums **(see Instruction 2)**.

Inadequate reserve factors have been generated for the extended term coverage on a basis independent of age and developed for a much younger cohort of insureds than those currently covered **(see Instruction 2)**.

Secure Term reserves have been calculated on the basis that the plan is 5-year term insurance. Most of the reserves calculated are really deficiency reserves **(see Instruction 2)**.

Reserves for the immediate payment of claims, and for non-deduction of deferred fractional premiums and the return of premiums at the death or the insured have not been established **(see Instruction 2)**.

Single Premiums, monthly outstanding balance premiums, refunds on terminations, and experience refunds are not reported separately. Reporting procedures with creditor policyholders should be established to accomplish this requirement. This process was implemented during 2000 **(see Instruction 2)**.

Extended term insurance reserves do not reflect the ages of the individuals insured. The Company does not use the same valuation interest rate that was used when the status of the policy was premium paying. The Company should revise its valuation of extended term insurance **(see Instruction 2)**.

Computational adjustments as reported in the **Notes and Comments to Financial Statements (notes 3, 4, 5, 6, 7)** will be made to the related actuarial asset and liability lines. The combined net effect of the noted adjustments will be a $148,385 decrease to the Company surplus.

SUBSEQUENT EVENTS

Ownership and Control: There have been no changes in ownership and control of the Company. However, during the subsequent years to the examination date, there were changes within the holding company system.

PEMCO Corporation separated into two separate companies effective July 1, 2000. CORP remains the owner of PLIC and continues to focus on computing services. The new company, PEMCO Technology Services, will concentrate on electronic transaction processing (formerly called PowerLink).

Territory and Plan of Operations: The Company has moved forward with product enhancements, improvements in marketing strategy, and an organizational shift from being primarily service oriented to creating a sales culture. These changes are intended to maximize the opportunities for cross-selling the Company's products through other PEMCO affiliated companies. The emphasis for cross selling is on the homeowners, bank and credit union markets by utilizing the existing customer relationships.

Subsequent to the examination period in 1999, preferred rates were introduced for the Secure Term product and during the year 2000, the Company has been pursuing the introduction of ultra-preferred rates for Secure Term and preferred/ultra-preferred rates for Cornerstone Whole life and credit insurance products.

EDP and Accounting Systems: The Company entered into a new remote processing agreement with Genelco to continue the outsourcing of the Life Administration System, effective January 31, 2000 for an additional three years. At the same time, the Life Administration Systems software was licensed for the license term of twenty-five years.

Reinsurance: The reinsurance contract with BMA on the Secure Term policies was renegotiated to a 50/50quota share with the retained amount not to exceed $100,000, effective June 1, 2000. The maximum amount was increased to $5,000,000.

<u>FINANCIAL STATEMENTS</u>

The following statements reflect the financial condition of the Company as of December 31, 1998, as determined by this examination:

Balance Sheet
As of December 31, 1998

Comparative Balance Sheet
As of December 31, 1997 and 1998

Statement of Income
Year Ended December 31, 1998

Comparative Statement of Income
For the Years Ended December 31, 1997 and 1998

Capital and Surplus Account
As of December 31, 1998

Comparative Capital and Surplus Account
Years Ended December 31, 1993 through 1998

Analysis of Examination changes in Financial Statements

PEMCO LIFE INSURANCE COMPANY

BALANCE SHEET

AS OF DECEMBER 31, 1998

	BALANCE PER COMPANY	EXAMINATION ADJUSTMENTS	BALANCE PER EXAMINATION	Notes
ASSETS				
Bonds	$5,709,625		$5,709,625	1
Cash and short term investments	753,712		753,712	2
Federal income tax recoverable	20,545		20,545	
Life insurance premiums and annuity considerations, deferred and uncollected	313,659	4,151	317,810	3
Investment income due and accrued	90,972		90,972	
Receivable from parent, subsidiaries and affiliates	2,335		2,335	
Aggregate write-ins for other than invested assets	1,680		1,680	
TOTAL ASSETS	$6,892,528	$4,151	$6,896,679	
LIABILITIES				
Aggregate Reserve for life policies and contracts	$1,303,043	$129,231	$1,432,274	4
Policy and contract claims: Life	64,231	38,266	102,497	5
Premiums and annuity considerations received in advance	38,428	(34,747)	3,681	6
Interest Maintenance Reserve	15,836		15,836	
Commissions to agents due or accrued	4,517		4,517	
General expenses due or accrued	42,048		42,048	
Taxes, licenses and fees due or accrued excl. FIT	2,099		2,099	
Cost of collection on premiums and annuity considerations	17,478	19,786	37,264	7
Asset Valuation Reserve	12,352	1,873	14,225	8
Payable to parent, subsidiaries and affiliates	49,733		49,733	
TOTAL LIABILITIES	1,549,765	154,409	1,704,174	
SURPLUS AND OTHER FUNDS				
Common capital stock	125,000		125,000	
Gross paid in and contributed surplus	75,000		75,000	
Unassigned funds (surplus)	5,142,763	(150,258)	4,992,505	
Capital and surplus	5,342,763	(150,258)	5,192,505	
TOTAL LIABILITIES, SURPLUS and OTHER FUNDS	$6,892,528	$4,151	$6,896,679	

PEMCO LIFE INSURANCE COMPANY

COMPARATIVE BALANCE SHEET

AS OF DECEMBER 31,

	1998		1997
ASSETS			
Bonds	$5,709,625		$6,093,685
Cash and short term investments	753,712		316,363
Federal income tax recoverable	20,545		28,180
Life insurance premiums and annuity considerations, deferred and uncollected	317,810	*	287,047
Investment income due and accrued	90,972		107,662
Receivable from parent, subsidiaries and affiliates	2,335		1,438
Aggregate write-ins for other than invested assets	1,680		
TOTAL ASSETS	$6,896,679		$6,834,375
LIABILITIES			
Aggregate Reserve for life policies and contracts	$1,432,274	*	$1,337,392
Policy and contract claims: Life	$102,497	*	45,148
Premiums and annuity considerations received in advance	$3,681	*	39,025
Interest Maintenance Reserve	$15,836		14,973
Commissions to agents due or accrued	$4,517		2,115
General expenses due or accrued	$42,048		52,715
Taxes, licenses and fees due or accrued excl. FIT	$2,099		13
Cost of collection on premiums and annuity considerations	$37,264	*	17,061
Asset Valuation Reserve	$14,225	*	15,439
Payable to parent, subsidiaries and affiliates	$49,733		45,744
Aggregate write-ins for liabilities			676
TOTAL LIABILITIES	1,704,174		1,570,303
SURPLUS AND OTHER FUNDS			
Common capital stock	125,000		125,000
Gross paid in and contributed surplus	75,000		75,000
Unassigned funds (surplus)	4,992,505	*	5,064,072
Capital and surplus	5,192,505		5,264,072
TOTAL LIABILITIES, SURPLUS and OTHER FUNDS	$6,896,679		$6,834,375

* As adjusted by examination

PEMCO LIFE INSURANCE COMPANY

SUMMARY OF OPERATIONS

YEAR ENDED DECEMBER 31, 1998

	BALANCE PER COMPANY	EXAMINATION ADJUSTMENTS	BALANCE PER EXAMINATION	Notes
INCOME				
Premiums and annuity considerations	$798,059		$798,059	
Net investment income	350,525		350,525	
Amortization of Interest Maintenance Reserve	737		737	
Commissions and exp. allowances on reinsurance ceded	3,150		3,150	
TOTAL INCOME	1,152,471		1,152,471	
BENEFITS				
Death Benefits	297,148		297,148	
Disability benefits and benefits under accident and health policies	30,449		30,449	
Surrender benefits and other fund withdrawals	2,994		2,994	
Increase in aggregate reserves for life and accident and health policies and contracts	(34,349)		(34,349)	
TOTAL BENEFITS	296,242		296,242	
EXPENSES				
Commissions on premiums and annuity considerations	36,106		36,106	
General insurance expenses	678,819		678,819	
Insurance taxes, licenses and fees, excl. fed. income tax	43,568		43,568	
Increase in loading on and cost of collection in excess of loading on deferred and uncollected premiums	417		417	
TOTAL BENEFITS and EXPENSES	1,055,152		1,055,152	
Net gain from operations before federal income tax	97,319		97,319	
Federal income taxes incurred (excl. tax on capital gains)	19,455		19,455	
NET INCOME	77,864		77,864	

PEMCO LIFE INSURANCE COMPANY

COMPARATIVE SUMMARY OF OPERATIONS
FOR THE YEARS ENDED DECEMBER 31,

	1998	1997
INCOME		
Premiums and annuity considerations	$798,059	$734,239
Net investment income	$350,525	362,233
Amortization of Interest Maintenance Reserve	$737	1,017
Commissions and exp. allowances on reinsurance ceded	$3,150	
TOTAL INCOME	1,152,471	1,097,489
BENEFITS		
Death Benefits	297,148	175,621
Disability benefits and benefits under accident and health policies	30,449	23,909
Surrender benefits and other fund withdrawals	2,994	1,808
Increase in aggregate reserves for life and accident and health policies and contracts	(34,349)	(72,052)
TOTAL BENEFITS	296,242	129,286
EXPENSES		
Commissions on premiums and annuity considerations	36,106	28,572
General insurance expenses	678,819	713,968
Insurance taxes, licenses and fees, excl. federal income tax	43,568	40,591
Increase in loading on and cost of collection in excess of loading on deferred and uncollected premiums	417	2,202
TOTAL BENEFITS and EXPENSES	1,055,152	914,619
Net gain from operations before federal income tax	97,319	182,870
Federal income taxes incurred (excl. tax on capital gains)	19,455	40,820
NET INCOME	77,864	142,050

PEMCO LIFE INSURANCE COMPANY

CAPITAL AND SURPLUS ACCOUNT

AS OF DECEMBER 31, 1998

	BALANCE PER COMPANY	EXAMINATION ADJUSTMENTS	BALANCE PER EXAMINATION	Notes
Capital and surplus on December 31, 1997	$5,264,072		$5,264,072	
GAINS AND (LOSSES) IN SURPLUS				
Net income	77,864		77,864	
Change in nonadmitted assets and related items	116		116	
Change in asset valuation reserve	3,088		3,088	
1998 Examination adjustments to surplus		(150,258)	(150,258)	3-8
Aggregate write-ins for gains and losses in surplus	(2,377)		(2,377)	
Net change in capital and surplus for the year	78,691	(150,258)	(71,567)	
Capital and surplus on December 31, 1998	$5,342,763	($150,258)	$5,192,505	

PEMCO LIFE INSURANCE COMPANY

COMPARATIVE CAPITAL AND SURPLUS ACCOUNT

AS OF DECEMBER 31,

	1998	1997	1996	1995	1994
Capital and surplus, December 31, prior year	$5,264,072	$5,099,841	$4,832,280	$4,504,440	$4,314,303
GAINS AND (LOSSES) IN SURPLUS					
Net income	77,864	142,050	268,867	293,802	186,900
Change in nonadmitted assets and related items	116	343	(386)	875	3,625
Change in asset valuation reserve	3,088	3,860	(4,169)	(3,669)	(563)
1998 Examination adjustments to surplus	(150,258)				
Aggregate write-ins for gains and losses in surplus	(2,377)	17,978	3,249	36,832	175
Net change in capital and surplus for the year	(71,567)	164,231	267,561	327,840	190,137
Capital and surplus, December 31,	$5,192,505	$5,264,072	$5,099,841	$4,832,280	$4,504,440

PEMCO LIFE INSURANCE COMPANY

ANALYSIS OF EXAMINATION CHANGES IN FINANCIAL STATEMENTS
AS OF DECEMBER 31, 1998

	Increase (Decrease)		Notes
CAPITAL and SURPLUS, per Company		$5,342,763	
ASSETS			
Life insurance premiums and annuity considerations, deferred and uncollected	4,151		3
LIABILITIES			
Aggregate Reserve for life policies and contracts	(129,231)		4
Policy and contract claims: Life	(38,266)		5
Premiums and annuity considerations received in advance	34,747		6
Cost of collection on premiums and annuity considerations	(19,786)		7
Asset Valuation Reserve	(1,873)		8
Net Increase/(Decrease) to surplus		(150,258)	
CAPITAL and SURPLUS, per Examination		$5,192,505	

NOTES AND COMMENTS TO FINANCIAL STATEMENTS

1. **BONDS** represent 82.84% of Total Assets and 106.86% of Total Surplus. Bonds are stated at amortized cost and all are investment grade bonds with a SVO rating of 1. At year-end 1997, the Company was not in compliance with the 4% limitation on investments in any one entity noted in RCW 48.13.030. The Chief Financial Analyst from the Office of Insurance Commissioner advised the Company in April 1998 of the violation and the Company immediately sold the excess investments during May 1998. The Company was in compliance at year-end 1998.

2. **CASH AND SHORT TERM INVESTMENTS** are 10.94% of Total Assets and 14.12% of Surplus. The balance consists of cash and $740,000 in three money market mutual funds and one repurchase agreement with an affiliated company all purchased during December 1998. All five are SVO class "1" issues. These were all valued at cost in accordance with the NAIC Valuations of Securities manual and the applicable section of the Washington Insurance Code.

3. **LIFE INSURANCE PREMIUMS DEFERRED AND UNCOLLECTED** is $313,659 which is 4.55% of Total Assets and 5.87% of Surplus. The OIC actuary has recalculated and recommended an increase in the amount of $4,151.

4. **AGGREGATE RESERVE FOR LIFE POLICIES AND CONTRACTS** is $1,303,043 which is 18.91% of Total Assets and 24.39% of Surplus. The OIC actuary has recalculated and recommended an increase in the amount of $129,231.

5. **LIFE POLICY AND CONTRACT CLAIMS** are $64,231 which is 0.932% of Total Assets and 1.202% of Surplus. The OIC actuary has recalculated and recommended an increase in the amount of $38,266.

6. **PREMIUMS AND ANNUITY CONSIDERATIONS RECEIVED IN ADVANCE** is $38,428 which is 0.558% of Total Assets and 0.719% of Surplus. The OIC actuary has recalculated and recommended a decrease in the amount of $34,747.

7. **"COST OF COLLECTION" ON PREMIUMS AND ANNUITY CONSIDERATIONS DEFERRED AND UNCOLLECTED IN EXCESS OF LOADING** is $17,478 which is 0.254% of Total Assets and 0.327% of Surplus. The OIC actuary has recalculated and recommended an increase in the amount of $19,786.

8. **ASSET VALUATION RESERVE (AVR)** is reported as $12,352 which is 0.179% of Total Assets and 0.231% of Surplus. The Company listed all short-term investments as exempt obligations in their determination of the AVR. The Annual Statement Instructions and the Securities Valuation Office Purposes and Procedures Manual would indicate that the Class One Money Market Funds held at year end, should be rated as NAIC 1. They therefore do not possess the qualifications to be Exempt Money Market Funds and should instead be reclassified to Short Term Bonds. A recalculation of the AVR after the reclassification would call for an increase of $1,873 to the 1998 AVR.

   The Asset Valuation Reserve should be completed as required by **WAC 284-07-050(2) and RCW 48.05.250**, according to the NAIC Annual Statement Instructions for Life, Accident and Health and the Securities Valuation Office Purposes and Procedures Manual **(see Instruction 2)**.

ACKNOWLEDGMENT

The cooperation extended to the examiners by the officers and employees of the Company during the course of this examination is hereby acknowledged.

In addition to Larry A. Omdal, Examiner in Charge, Constantine Arustamian, CPA, John R. Jacobson, AFE, IS Specialist, Peter M. Mendoza, CFE, CIE and Life and Disability Actuary, Roy C. Olson, FSA, MAA all from the Office of Insurance Commissioner, State of Washington, participated in the examination and preparation of this report.

State of Washington)
) ss.
County of King)

Larry A. Omdal, being duly sworn, deposes and says that the foregoing report subscribed by him is true to the best of his knowledge and belief.

Larry A. Omdal
Examiner in Charge

Subscribed and sworn to before me on this 24th day of October, 2002.

COLLEEN JANSEN
COMMISSION EXPIRES
NOTARY PUBLIC
4-1-04
STATE OF WASHINGTON

Notary Public in and for the
State of Washington,
residing at Seattle